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CREATIVE DESTRUCTION!

It's been said the stock market hates uncertainty. Well . . . it had a strange way of showing it in 2016.

The year began with fears an economic crisis in China would drag the rest of the world into recession. At mid-year, the British stunned the world by voting to exit the European Union—surely another nail in the coffin of the sclerotic European economy. Then came the rancorous US election. A Trump victory was widely believed to be both highly unlikely and a big negative for the stock market.

Despite all the fear and loathing, the US stock market bobbed and weaved its way to solid double-digit returns in 2016—confounding conventional wisdom, embarrassing the so-called experts, and rebuking and upending the political establishment.

What's an investor to make of this helter-skelter world? With the benefit of hindsight, we view the political events of 2016 as acts of "creative destruction." In the 1940s, economist Joseph Schumpeter coined the term to describe a process of industrial mutation that "incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism."

Creative destruction is a disruptive and chaotic force often resisted by entrenched interests, but one that's essential to economic progress. Examples are numerous. In 1900, it took 40% of our workforce to feed a nation of 90 million. Today agriculture is 2% of the workforce. Not only do we more than adequately feed 320 million Americans, but farming runs a trade surplus (we export more farm products than we import). Amazon and Internet retailing are replacing many bricks and mortar retail locations. Desktop computers replaced the minis and the mainframes. You get the picture.

In 2016 investors saw creative destruction at work in the political realm. Remember Howard Beale's famous rant in the 1976 movie *Network*: "I'm mad as hell and I'm not going to take it anymore!" That's what many voters said to the political establishment in 2016.

It's a mistake, however, to view the recent US presidential election simply as a one-off upset victory for Republicans who happened to nominate the most "non-establishment" of candidates. What happened in the US is part of an emerging global political trend which started with Brexit and will continue in 2017 and beyond.

The core constituencies underpinning the Brexit and Trump votes were quite similar—generally older, rural working class whites who felt threatened by immigration and globalization and neglected by big government. As a political force in the western democracies, they represent an angry group of voters who perceive themselves as the "biggest losers" from globalization—the process of increasing integration of world economies through free flow of international trade, capital and labor.

This month, Ipsos Mori published the latest in its annual Perils of Perception series, a 40 country survey of public perceptions about "key global issues and features of the population." . . . Ipsos Mori carried out its survey before the US election on November 8. One of the questions it asked was who respondents thought would win the election. Only three countries thought Donald Trump would be elected: Russia, China and Serbia.

~ Financial Times
December 31, 2016

Note: Ipsos Mori is a research service based in Edinburgh, Scotland. In the poll cited, US results were 26% for Trump and 50% for Clinton.

By and large, these middle-class voters are correct in their perception, at least in a relative sense. Over the past few decades, globalization has been a boon to global prosperity, but the benefits haven't been evenly distributed. The biggest winners from globalization have been emerging market economies and, within the developed economies, better educated upper-income workers.

We haven't heard the last from these angry voters. In the first half of 2017, there will be general elections in France and the Netherlands where nationalistic, anti-immigrant, anti-globalization candidates will challenge the establishment. In September, Catalonia, the region of Spain where much of the country's wealth and industry is concentrated, will hold a referendum on independence. In October, there's an election in Germany, the linchpin of economic stability in the EU.

From an investment viewpoint, there are both good and bad aspects to the recent creative destruction of the political establishment. The Brexit and Trump votes had strong anti- government, anti-regulation components. Less onerous regulations will help unleash the animal spirits of the British and American economies. One key reason economic growth in the developed world has been so sluggish is lackluster growth in productivity (output per hour worked). Eliminating unnecessary regulations boosts productivity and hence economic activity.

International trade: products and people

The anti-immigrant and anti-globalization components of the Brexit and Trump votes are potentially more troubling. Severe restraints on immigration and overly protectionist trade policies could grind economic activity to a halt.

Why is immigration important for US economic growth? Because growth in the US labor force is increasingly dependent on immigrants and their children. The aging of the postwar baby boom and a downturn in fertility rates has led to a sharp decline in the growth of our native born population. (Last year the US population grew 0.7%, the slowest pace since 1937.) Around the year 2000, the majority of the growth in the US working age population began to be fueled by immigrants. Without them, the US workforce could actually begin to decline in the 2020s.

A simple but useful way to analyze economic growth is to view it as a function of growth in the labor force and growth in productivity—more workers plus more output per worker produces more growth. Over the past 50 years, US real gross domestic product (GDP) has grown at about 3.2% annually, with labor force and productivity contributing roughly equal amounts. Over the past 5 years, however, the US economy has grown at about 1.5% annually, as labor force growth declined to about 0.6% and productivity to about 0.9 %. Restrictive immigration policies could eventually foster labor shortages and raise inflation and interest rates.

Protectionist trade policies would have a more immediate effect, first on the stock market and then on the economy. During the presidential campaign, there was much misinformation and "fake news" perpetrated by both Democrats and Republicans on the subjects of international trade and the US manufacturing sector. Here's my take on a few of the issues we heard about from the candidates.

Free trade agreements (FTAs) have hurt the US economy. American industry is battered by cheap foreign labor and unfair trade practices, but there's scant

World's Top Five Manufacturing Countries

Ranked by Percent of Global Market Share

Rank	Country	% of World Mfg.	Mfg. Output per Capita	Merchandise Exports ($bn)	Compensation Costs/ per hr.
1	China	23.2%	$1978	$2143	$3.50
2	USA	17.2%	$6338	$1510	$37.71
3	Japan	7.8%	$7211	$622	$23.60
4	Germany	6.3%	$9008	$1309	$42.42
5	South Korea	3.1%	$7519	$539	$22.68

Sources: CIA Fact Book, Congressional Research Services, United Nations and MAP Foundation, Atlanta Capital
Note: Data is 2013, 2014, 2015 based on availability

As an adjective, the word "elite" still conveys something positive, even aspirational. . . But as a noun, embodied by actual living people, it has become one of the nastiest epithets in American politics. "Elites have taken all the upside for themselves and pushed the downside to the working and middle class Americans," complains Trump's adviser Steve Bannon (of Harvard, Goldman Sachs and Hollywood)

~ The New York Times Magazine, "Power Down" by Beverly Gage
January 8, 2017

evidence it's due to the 20 countries where we have FTAs. The US trade deficit is primarily due to countries (like China) where we have no FTA. The 20 FTA countries account for about half of our exports and one-third of our imports. In 2015, we had a modest trade surplus with these countries due to the fact that we export more services (financial, travel, engineering, etc.) than we import. In the goods producing sector, we did have a trade deficit, but that's largely due to oil imports from Canada. The US Chamber of Commerce likes to point out that "the United States has recorded a trade surplus in manufactured goods with its FTA partner countries in each of the last five years."

The US is losing good paying manufacturing jobs to foreign countries like Mexico. We are indeed, but we are also gaining good paying jobs from foreign countries. During the recent economic expansion, US manufacturing jobs have actually increased from a low of 11.5 million in 2010 to 12.3 million currently. Foreign companies account for more than 2 million factory jobs, one-sixth of total factory employment. Here in the southeast US, employment has benefited from an influx of foreign automakers. BMW employs over 8000 at its plant in Spartanburg, South Carolina where its entire line of high end SUVs are made. About 70% of the output is exported, which makes BMW the largest exporter of cars made in the US. If you live in Berlin and want to buy a BMW X5, it is made in and exported from SC. (Imagine what would happen if Angela Merkel decreed that all BMWs must be made in Germany!)

American manufacturers are not competitive in world markets. Not so. US manufacturers do face challenges from abroad, but so do manufacturers from most other developed countries. While the portion of the US work force engaged in manufacturing has steadily declined over the past few decades, the portion of our GDP from manufacturing has remained remarkably stable at about 12% since the 1960s. What's more, the portion of exports in the US economy has increased from about 5% in the early 1960s to almost 13% currently. Two thirds of US exports are manufactured goods. As the table shows, the US ranks second in global manufacturing and second in merchandise exports. Also note that Germany, an economy that exports over 40% of its output and one that's about one-fifth our size, is quite competitive on the world stage despite high wages. Labor costs are only one element in plant relocation decisions.

If you believe the "conventional wisdom" that US manufacturers are getting their brains beat out by foreign competition, you probably shouldn't invest in the US

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stock market. Manufacturing companies make up about one-third of the market capitalization of the Russell 2000® stock index and almost 50% of the S&P 500®. What US manufacturers are experiencing today is not much different than what US agriculture went through in the early 20th century—a chaotic, technology led transformation to much higher productivity. Creative destruction in manufacturing is unlikely to be stopped by higher tariffs or a border tax on US imports.

Entering 2017, the global economy can best be described as benefiting from a synchronized acceleration led by the US. With industrial activity and commodity prices on the rise worldwide, you can forget about deflation and popular catch phrases like "the new normal" and "lower for longer." It appears that "the old normal" is back, with better economic growth, rising inflation and rising interest rates. In this environment it's no wonder that the stock market's most cyclical sectors—Financials, Energy, Industrials and Materials—sharply outperformed the market in late 2016, while defensive groups like Health Care, Consumer Staples, Utilities and Real Estate lagged.

The ghosts of Reed Smoot and Willis Hawley are haunting the presidency of Donald J. Trump, even before it begins. . . . Sen. Smoot and Rep. Hawley co-sponsored America's infamous Smoot-Hawley Tariff Act of 1930, which hiked tariffs on imports to record levels. A global trade war resulted, as other countries responded in kind. US foreign trade plunged by 40%, which helped drag the economy into the Great Depression.

~Barron's
cover story by Gene Epstein
December 19, 2016

Many investors expect a Trump presidency to unleash "animal spirits" in the US economy through lower taxes, less regulation and more infrastructure spending. It's a reasonable assumption. Following the election, the US stock market began its so-called Trump rally. Surveys of business and consumer confidence did improve, so if there is any widespread disenchantment with a Trump victory, it is not showing up in the sentiment surveys.

It's important to realize, however, global economic indicators were improving before the election. Fears about China never materialized last year. European economies continued to putter along despite the upheaval caused by Brexit and the migration crisis. Industrial activity and corporate earnings in the US began to improve in late summer after a two-year hiatus caused by the collapse of commodity prices.

Investors face two key risks in the months ahead: a potential trade war and an overheated US economy which sparks a sharp rise in inflation and interest rates. The long period of super easy monetary policy has finally succeeded in reflating the global economy. The 35-year bull market in bonds probably ended in 2016 and the end to the nearly eight-year bull market in stocks is beginning to come into view. So far at least, I don't see deterioration in the leading economic indicators or in the credit markets which would signal a major market decline. But with valuations at lofty levels and interest rates rising, equity investors should not expect double-digit returns in 2017 and the returns that they do get are likely to be front-end loaded into the first half of the year. ☘